RB-2001-03 Guidance on Nondeposit Investment Sales

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BACKGROUND

Increasingly, credit unions are expanding their activities to include recommending or selling nondeposit investment products, such as mutual funds and annuities, to their members. In response to the increased activity, this Bulletin was developed to provide guidance to credit unions on various issues raised by nondeposit investment sales. Each credit union should address these issues in a manner appropriate to the nature and extent of nondeposit investment sales activities conducted by its organization.

INTRODUCTION

The ability of credit unions to sell diverse and complementary financial products and services helps members to meet specific financial objectives, benefits members by promoting competition, and can make these products and services available to members that are underserved or unserved by other distribution systems.

Adequate member protections, qualified employees, and appropriate sales practices are key to responsible nondeposit investment sales activities. The Department is committed to ensuring that credit unions' nondeposit investment sales activities meet high standards.

Sales activities for nondeposit investment products should ensure that members are clearly and fully informed of the nature and risks associated with these products. In particular, where nondeposit investment products are recommended or sold to members, credit unions should ensure that members are fully informed that the products:

• Are not insured by the NCUSIF;

• Are not deposits or other obligations of the credit union and are not guaranteed by the credit union; and

• Are subject to investment risks, including loss of principal invested.

Additionally, sales activities involving these investment products should be designed to minimize the possibility of member confusion and to safeguard the credit union from liability under the applicable anti-fraud provisions of federal law, which, among other things, prohibit materially misleading or inaccurate representations in connection with the sale of certain products or services.

APPLICABILITY

This Bulletin applies when recommendations or sales of nondeposit investment products are made by:

• Employees of the credit union;

• Employees of a third party, which may or may not be affiliated with the credit union (including telephone sales or recommendations by employees or from the credit union's premises and sales or recommendations initiated by mail from its premises); and

• Sales resulting from a referral of members by the credit union to a third party when the credit union receives a benefit for the referral.

POLICIES AND PROCEDURES

A credit union involved in the activities described above for the sale of nondeposit investment products should adopt a written statement that addresses the risks associated with the sales program and contains a summary of policies and procedures outlining the features of the credit union's program that addresses, at a minimum, the concerns described in this Bulletin. The written statement should address the scope of activities of any third party involved, as well as the procedures for monitoring compliance by third parties in accordance with the guidelines below. The scope and level of detail of the statement should appropriately reflect the level of the credit union's involvement in the sale or recommendation of nondeposit investment products. The credit union's statement should be adopted and reviewed periodically by its board of directors. Credit unions are encouraged to consult with legal counsel with regard to the implementation of a nondeposit investment product sales program.

The credit union's policies and procedures should include the following:

• **Compliance procedures**. The procedures for ensuring compliance with applicable laws and regulations and consistency with the provisions of this Bulletin.

• **Supervision of sales personnel**. A designation by senior management of specific individuals to exercise supervisory responsibility for each activity outlined in its policies and procedures.

• **Types of products sold**. The criteria governing the selection and review of each type of product sold or recommended.

• **Permissible use of member information**. The procedures for the use of information regarding members for any purpose in connection with the sale of nondeposit investment products.

• **Designation of employees to sell products**. A description of the responsibilities of those personnel authorized to sell nondeposit investment products and of other personnel who may have contact with members concerning the sales program, and a description of any appropriate and inappropriate referral activities and the training requirements and compensation arrangements for each class of personnel.

ARRANGEMENTS WITH THIRD PARTIES

If a credit union directly or indirectly engages in activities as described above under which a third party sells or recommends nondeposit investment products, the credit union should, prior to entering into the arrangement, conduct an appropriate review of the third party. The credit union should have a written agreement with the third party that is approved by the credit union's board of directors. Compliance with the agreement should be periodically monitored by the credit union's senior management. At a minimum, the written agreement should:

• Describe the duties and responsibilities of each party, including a description of permissible activities by the third party on the credit union's premises; terms as to the use of the credit union's space, personnel, and equipment; and compensation arrangements for personnel of the credit union and the third party.

• Specify that the third party will comply with all applicable laws and regulations and will act consistently with the provisions of this Bulletin and, in particular, with the provisions relating to member disclosures.

• Authorize the credit union to monitor the third party and periodically review and verify that the third party and its sales representatives are complying with its agreement with the credit union.

• Authorize the credit union and the Department to have access to such records of the third party as are necessary or appropriate to evaluate such compliance.

• Require the third party to indemnify the credit union for potential liability resulting from actions of the third party with regard to the investment product sales program.

• Provide for written employment contracts, satisfactory to the credit union, for personnel who are employees of both the credit union and the third party.

GENERAL GUIDELINES

1. Disclosures and Advertising

The Department believes that recommending or selling nondeposit investment products to members should occur in a manner that assures that the products are clearly differentiated from insured shares and deposits. Conspicuous and easy to comprehend disclosures concerning the nature of nondeposit investment products and the risk inherent in investing in these products are one of the most important ways of ensuring that the differences between nondeposit products and insured shares and deposits are understood.

<u>Content and Form of Disclosure</u>. Disclosures with respect to the sale or recommendation of these products should, at a minimum, specify that the product is:

• Not insured by the NCUSIF;

• Not a deposit or other obligation of , or guaranteed by, the credit union; and

• Subject to investment risks, including possible loss of the principal amount invested.

The written disclosures described above should be conspicuous and presented in a clear and concise manner. Credit unions may provide any additional disclosures that further clarify the risks involved with particular nondeposit investment products.

<u>Timing of Disclosure</u>. The minimum disclosures should be provided to the member:

• Orally during the sales presentation,

• Orally and in writing prior to or at the time an investment account is opened to purchase these products, and

• In advertisements and other promotional materials, as described below.

A statement signed by the member should be obtained at the time such an account is opened, acknowledging that the member has received and understands the disclosures.

Confirmations and account statements for such products should contain at least the minimum disclosures if the confirmations or account statements contain the name or the logo of the credit union. If a member's periodic share account statement includes account information concerning the member's nondeposit investment products, the information concerning these products should be clearly separate from the information concerning the share accounts, and should be introduced with the minimum disclosures and the identify of the entity conducting the nondeposit transaction. (Note: These minimum disclosures are in addition to any other disclosures required by applicable law.)

<u>Advertisements</u>. Advertisements and other promotional and sales material, written or otherwise, about nondeposit investment products should conspicuously include at least the minimum disclosures discussed above and must not suggest or convey any inaccurate or misleading impression about the nature of the product or its lack of NCUSIF insurance. The minimum disclosures should also be emphasized in telemarketing contacts. Any third-party advertising or promotional material should clearly identify the company selling the nondeposit investment product and should not suggest that the credit union is the seller. If brochures, signs, or other written material contain information about both insured shares and nondeposit investment products, these materials should clearly segregate information about nondeposit investment products from the information about shares and other insured deposits.

2. Sales Area

Selling or recommending nondeposit investment products on the premises of a credit union may give the impression that the products are NCUSIF-insured or are obligations of the credit union. To minimize member confusion with share and deposit accounts, sales or recommendations of nondeposit investment products on the premises of a credit union should be conducted in a physical location distinct from the area where shares and deposits are taken. Signs or other means should be used to distinguish the investment sales area from the share- and deposit-taking area of the credit union. However, in the limited situation where physical consideration prevent sales of nondeposit products from being conducted in a distinct area, the credit union has a heightened responsibility to ensure appropriate measures are in place to minimize member confusion.

In no case, however, should tellers and other employees, while located in the routine share- and deposit-taking area, such as the teller window, make general or specific investment recommendations regarding nondeposit investment products or accept orders for such products, even if unsolicited. Tellers and other employees who are not authorized to sell nondeposit investment products may refer members to individuals who are specifically designated and trained to assist members interested in the purchase of such products.

3. Qualifications and Training

The credit union should ensure that its personnel who are authorized to sell nondeposit investment products or to provide investment advice with respect to such products are adequately trained with regard to the specific products being sold or recommended. Training should not be limited to sales methods, but should impart a thorough knowledge of the products involved, of applicable legal restrictions, and of member protection requirements. If credit union personnel sell or recommend securities, the training should be the substantive equivalent of that required for personnel qualified to sell securities as registered representatives.

Credit union personnel with supervisory responsibilities should receive training appropriate to that position. Training should also be provided to employees of the credit union who have direct contact with members to ensure a basic understanding of the credit union's sales activities and the policy of limiting the involvement of employees who are not authorized to sell investment products to member referrals. Training should be updated periodically and should occur on an ongoing basis.

Credit unions should investigate the backgrounds of employees hired for their nondeposit investment products sales program, including checking for possible disciplinary actions by securities and other regulators if the employees have previous investment industry experience.

4. Suitability and Sales Practices

Credit union personnel involved in selling nondeposit investment products must adhere to fair and reasonable sales practices and be subject to effective management and compliance reviews with regard to such practices. In this regard, if credit union personnel recommend nondeposit investment products to members, they should have reasonable grounds for believing that the specific product recommended is suitable for the particular member on the basis of information disclosed by the member. Personnel should make reasonable efforts to obtain information directly from the member regarding, at a minimum, the member's financial and tax status, investment objectives, and other information that may be useful or reasonable in making investment recommendations to that member. This information should be documented and updated periodically.

5. Compensation

Personnel who are authorized to sell nondeposit investment products may receive incentive compensation, such as commissions, for transactions entered into by members. However, whenever an employee is compensated for a sale or referral, the credit union needs to be sensitive to the concern that the employee might be motivated by the prospect of financial reward for the sale or referral rather than the best interest of the member. Accordingly, incentive compensation programs must not be structured in such a way as to result in unsuitable recommendations or sales being made to members and the credit union should clearly communicate to its sales personnel that it is unacceptable to engage in high pressure sales tactics.

Credit unions compliance and audit personnel should not receive incentive compensation directly related to results of the nondeposit investment sales program.

6. Compliance

Credit unions should develop and implement policies and procedures to ensure that nondeposit investment product sales activities are conducted in compliance with applicable laws and regulations, the credit union's internal policies and procedures, and in a manner consistent with this Bulletin. Compliance procedures should identify any potential conflicts of interest and how such conflicts should be addressed. The compliance procedures should also provide for a system to monitor member complaints and their resolution. Where applicable, compliance procedures also should call for verification that third party sales are being conducted in a manner consistent with the governing agreement with the credit union.

The compliance function should be conducted independently of nondeposit investment product sales and management activities. Compliance personnel should determine the scope and frequency of their own review, and findings of compliance reviews should be periodically reported to the credit union's board of directors.

CONCLUSIONS

The Department's evaluation of a credit union's nondeposit investment sales activities will be guided by the Department's supervision-by-risk approach, which focuses on identifying problems, or potential problems, in individual credit unions or the credit union system, and ensuring that problems are appropriately corrected. The Department applies this philosophy in all supervisory activities it conducts.

The types of risk most likely to arise in connection with nondeposit investment sales include reputation risk, compliance risk, transaction risk, and strategic risk. In general, experience has demonstrated that credit unions conduct their nondeposit investment sales activities in a safe and sound manner and that their activities have been responsive to the interest of their members.

The Department believes that it can identify and focus on key indicators of potential problems with a credit union's sales of nondeposit investments as part of the examination process, and will be developing additional instructions to guide its examiners in this area.